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Milk Regulation in Montana

by
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Government price control is an old institution. If often has been supported by businessmen eager to escape the discipline of the free market as well as by public officials determined to reestablish order in chaotic economies. Generally, the achievements of public price-fixing have been dismal. Gross inequities and inefficiencies stemming from controls tend to mar the operation of an economic system. During the Fourth Century A.D., the Roman Emperor Diocletian's mammoth attempt at price regulation brought his empire to the brink of financial and social ruin. More recently, President Richard Nixon's program to stifle the nation's inflationary spiral with wage and price restraints only made a healthy recovery more difficult.

Montana's forty-four year experience with milk price regulation has not proven as harrowing as the trials of Diocletian and Nixon. It has, however, provoked enough controversy to warrant a critical analysis by policy makers. This report addresses several questions concerning the past activities of, and future options for, government supervision of the dairy industry in Montana.

Early History of Regulation

The Great Depression had a devastating impact on Montana's prosperous dairy industry. To meet falling consumer demand, milk dealers engaged in frantic price cutting and giveaway schemes to attract customers. Producers faced the fact that raw milk is highly perishable and must be marketed promptly. Public health officials worried that cost-conscious producers and processors would cut corners too sharply and jeopardize the quality of milk products. By 1934, milk industry representatives, government officials, and some concerned citizens decided that a free market was not a suitable arrangement for producing and distributing dairy products.

After a brief but unsuccessful attempt at self-regulation of industry practices under New Deal price codes, dairymen decided to lobby for government controls. Strong bipartisan support assured the passage of the first Milk Control Act in 1935. A three-member board was granted temporary emergency powers to set and enforce prices that would cover production costs and help assure suitable profit margins in the industry. In 1939, the milk lobby convinced lawmakers that the temporary arrangement should be made permanent. A new five-member board, heavily weighted

with industry representatives, was created and given stronger price-fixing authority.

Economic order returned to the dairy industry by the mid 1940's. It is difficult to say whether regulation or the war economy was primarily responsible for the recovery. The board was aggressive in extending price controls to most areas of the state. Dairymen were united in their support of board activities.

By the late 1950's there were indications that milk regulation was a shambles. Tension between economic transformation of the industry and administration of the milk control law had reached a critical stage. When the law was first implemented, most dairy farmers produced, processed, and distributed their own milk, and producers, producer-distributors, and distributors each were entitled to one seat on the milk board. By the 1950's the old distributor operation was being replaced by separate production and processing-marketing firms, although producer-distributors were still entitled to board representation. The Montana Dairy Producers Association argued that the allocation of seats on the board was now weighted in favor of distributor interests. Similarly retail trade associations, noting that their members were picking up a greater share of consumer sales when compared with direct home delivery, argued for representation on the board.

1957 Legislative Investigation

These arguments spawned a special legislative investigation of the industry and the board in early 1957. A joint, select committee uncovered evidence not only of inadequacies in existing law but also instances of failure to administer the law properly. The extreme perishability of milk still kept producers within a "sell quickly or dump" squeeze, and this problem was sometimes aggravated by unscrupulous distributors who bullied producers and cheated them on purchase reports. A common trick was to inform producers that their raw milk was destined for production of ice cream, cheese, or animal feed. The price paid to producers for these purposes was uncontrolled and therefore set at the discretion of distributors. Some distributors would deliberately set low prices for the raw milk, process it for drinking purposes, and sell it at the higher, uncontrolled price. The profit gained by this unethical transaction was hard to uncover, since reporting requirements under the law were weak and lacked uniformity.

The investigating committee also determined that the

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board and its staff were often incompetent, indecisive, or deliberately unfair when administering the law. One shrewd board member, who represented milk distributors, had used his position to some business colleagues' advantage. Prices affecting producers had not been adjusted for years, and there were strong suspicions of "behind-closed-doors" deals between industry representatives and board members. One source close to the dairy industry summed up the situation by claiming that economic events and regulatory powers were almost completely at the disposal of distributors and to the detriment of producers and the public.

The report of the committee came too late in the legislative session to instigate a comprehensive reform package. Legislators and the governor settled, temporarily, for two cosmetic changes — revising the allocation of seats on the board to give producers more clout, and appointing new individuals to the restructured board. Between legislative sessions, representatives from all segments of the industry grudgingly agreed to compromise their differences and clean their own house, lest the legislature repeal the entire law. Lobbyists eventually produced a reform bill which strengthened reporting requirements and tempered other inadequacies of the law. The most striking innovation was the proviso that only consumers could sit on the new five-member board. Supposedly, public members would supervise dairy industry practices impartially. The 1959 legislature adopted this compromise, perhaps hoping that this episode would conclude the controversial history of the Milk Control Board.

Current Criticism of Regulation

Producers and distributors have continued to war with one another over the structure of milk price regulation, although the producers' position has improved remarkably since 1959. In recent years, controversy has shifted in the direction of consumer antagonism against the board. Recent public opinion surveys indicate significant resentment over frequent increases in the price of fluid milk. Several individuals have publicly argued for the abandonment of controls and elimination of the Milk Control Board. Ironically, these criticisms come at a time when the board is required by law to give considerable weight to consumer opinion and purchasing power, and has, in fact, made sincere attempts to carry out these provisions.

The widespread sentiment that prices are needlessly high and reflect industry influence is supported by empirical studies. The Montana Legislative Auditor's report on price control, published in 1976, sharply criticized the consequences of controlling retail and wholesale prices in the dairy industry. (Wholesale prices are the charges paid to processor-distributors by retail outlets.) Some board members also have publicly voiced these concerns.

High on the list of complaints is the large distributor gross margin (DGM). The DGM is the difference between what distributors pay producers for milk and the retail price. Montana's DGM is considerably higher than those of adjacent and similar states and it exceeds California's average by 47 percent. Critics also focus on net profit margins (profit as a percentage of net equity) for milk distributors. Montana's average is approximately 18 percent, whereas the national average is about eight percent. Contrary to industry views, the high margins are not due to transportation costs. Rather, they reflect inefficiencies in

processing and marketing that generally do not exist under competitive conditions. For example, fluid milk is almost always sold at the same price regardless of whether it is brought directly to your home or obtained from the supermarket, and whether it is sold in plastic or paper containers.

Another criticism leveled against controls is that retailers rarely price their milk above the minimum charge specified by the board. The board does not set maximum prices. Since the minimum price is normally used regardless of location and transportation costs, critics believe that the board may be overpricing milk. Critics also point to lower milk prices in similar states and on federal installations not covered by state law, noting that reasonable profits can apparently be made under competitive arrangements.

Estimates of consumer demand for milk priced under government control suggest that over a period of years overpricing has probably led to smaller milk purchases by the public than would have been made in a competitive market. This has the consequence of cutting down the income of dairy producers and channeling overpayments into the processing-distribution sector. It is consequently argued that the Milk Control Act has great potential for wrecking, not salvaging, much of the dairy industry.

Producer price controls have not come under much fire. Many economists believe that dairy farmers produce a unique commodity under severe biological and economic constraints. While some measure of price protection has been supported, there also is fear that too much protection may act as a disincentive. High incomes generated by price controls can induce and protect inefficient production methods, something not in the interest of consumers.

The Milk Control Board has recognized some of these problems in recent years and has attempted to correct them through the administrative process. Proposals to adjust pricing formulas in 1976 and 1978 would have had the indirect effect of generating competition and reducing some profit margins in the industry. At the request of distributors, both proposals were overturned in district court. A more ambitious plan to make price increases less frequent and to lower excess profits in the distribution sector recently has been adopted in part. There is no indication whether dairy lobbyists will challenge this modification in the courts. The frustrations experienced by the board in recent years, combined with the evidence reviewed, have convinced some board members that only deregulation of wholesale and retail prices will best serve the public interest. The board, however, does not have authority to suspend controls.

Arguments of the Industry

The dairy industry has successfully resisted efforts to weaken the regulatory structure, although arguments in favor of continuing the status quo have changed somewhat over time. Today, milk dealers are more concerned about monopolization of their industry should controls be abolished. Distributors fear that without price protection the largest distributors — including one major chain grocery store which processes and sells its own brand — will deliberately slash prices in order to steal customers from economically weaker firms. Many distributors would be forced to quit because of "cutthroat" competition, and there would be a domino effect on producer-suppliers. The market eventually would regain equilibrium with, say, only

one or two distributors, fewer producers, and higher, monopoly prices for milk products. Some dealers predict even more dire results. They see financial disaster extending to so many Montana dairymen that out-of-state suppliers, charging extremely high prices, would be necessary to meet consumer demand. In short, many dairymen conclude that controls preserve, rather than destroy competition.

From both a theoretical and an empirical perspective, the above arguments are rather specious. The distribution end of the Montana dairy industry already is an oligopoly; a few firms operate in a market where each firm's pricing activities are highly interrelated and sensitive. Oligopolies tend toward price stability. Because one firm's price-cutting action would only provoke the same by other firms, a no-win situation becomes evident. Extreme price-cutting is rare. Similarly, no one firm could raise prices without its competitors attracting the firm's customers by keeping their prices stable. Unless the firms act in concert, increases cannot be maintained. Action of this kind constitutes price-fixing and is illegal under federal and state law. In addition, price gouging designed to eliminate competition is unlawful and can command stiff penalties. Several Montana distributors did engage in illegal price-fixing in the mid-1960's and were fined accordingly. However, this should not be an excuse for substituting inefficient price controls for antitrust enforcement. With the additional provision of a posting requirement, whereby all firms "post" their prices regularly with regulatory agencies, any possibility of deviant price behavior by oligopolies can be controlled.

One should not ignore the fact that development of oligopoly in the distribution business and decline in the number of dairy farms have taken place during a period of state regulation. One individual close to the industry has privately described the distribution network as a shared monopoly. In April 1979, two firms alone controlled 57 percent of fluid milk distribution. Another dramatic development is the reduction in the number of dairy farmers over the past forty years. Even price control cannot protect grossly inefficient operation.

The experience of several states with resale price deregulation serves as a counterweight to industry fears of monopoly control. Many distributors in these states have stayed in business when competition forced them to innovate. Many dairy producers have also continued to thrive. Frequently, departure from the industry is the result of carelessness and not deregulation. A Federal Trade Commission report suggests that states like Montana with a small population and large territory could sustain several small and medium-level dairy operations due to location and transportation advantages not always present in smaller or more population-dense regions. Deregulation in Montana would not likely be a cure worse than the disease.

Past Reform Attempts

Before considering a workable alternative to the existing Milk Control Act, it is important to mention possible avenues to reform. There have been several attempts to alter significantly the regulatory structure in Montana, and each has been fraught with booby-traps.

Some critics have sought a judicial opinion declaring price regulation unconstitutional. The Montana Supreme Court made it clear in *Milk Control Board v. Rehberg* (1962) that it would not make substantive judgments about

the economic worth of price controls; this was and remains a legislative prerogative. Although high courts in three states have ruled that milk price controls violate private property and due process rights, these decisions were based on a substantive due process doctrine frowned on by most courts, including Montana's.

Legislators bent on reform also have not had much success. Several proposals to eliminate controls or give the board freedom to establish differentials in pricing have been quashed at the committee stage since 1937. Although two deregulation bills finally survived House committee review in 1979, they died on the floor by two-to-one margins. Dairy producers, distributors, and retailers are well organized and have weight in legislative circles.

Consumers are not well organized and their viewpoints are not widely disseminated and considered. Proponents of regulation use this vacuum to assert that the public is not really concerned about milk prices. The plausibility of this argument must be challenged. Consumerism, in the jargon of economists, is a "public good." The costs of achieving consumer goals — hiring lobbyists, appearing to present testimony, taking time away from job or home — are enormous to one individual and are typically shoved upon one's neighbor, who in turn passes the burden, and so on. Unless costs are shared to reduce individual burdens, public goals cannot be easily expressed or achieved.

An organized public effort will be necessary to change the milk control law, but convincing legislators to make the change also will require a thorough understanding of political realities. Not all Republican legislators can be expected to support deregulation, even though their party generally advocates the free market concept. Many Republicans represent rural areas and share constituents' fears that decontrol will hurt the local economy. Rural Democrats often find themselves in a similar situation. Other lawmakers have not been able to sort out the fallacious arguments made by industry lobbyists. To date, only urban-liberal Democrats and a few urban Republicans have publicly supported deregulation. A legislative change in the Act will come only when urban, and some rural, legislators are convinced that the available evidence supports deregulation as a more equitable public policy.

Some reformers have considered the initiative process as a substitute for slow and stubborn legislative machinery. Deregulation may be so controversial that only a popular vote can settle the issue; the table wine initiative of 1978 is a good example. However, the language of an initiative may be so poorly structured that unintended interpretations and legislative backlash result. An alternative to legislation or an initiative is to rely on the existing board to meet public preferences, but this process can be easily manipulated by the dairy industry. The administrative hearing process is a lawyer's paradise. Unorganized or seemingly "unprofessional" consumer views are easy targets in such a setting; substantive arguments are often derailed by procedural technicalities.

Conclusion

When judged by many of its aims, the Montana Milk Control Act has been a failure. It has promoted several economic inefficiencies damaging to the industry and the public. It cannot prevent the closure of many milk dealers, but it has potential for granting undue political and

economic advantage, especially to the processing and distribution sectors. Despite the consumer orientation of the present board, the absence of broad public participation and the limits of the law allow free play to industry pressures. The feeling of some regulators that the Administrative Procedures Act unfairly limits speedy and effective action by the board for everyone's benefit is well-taken, but the prospect of an administrative agency operating without consistent and equitable procedures is an undesirable alternative. Besides, this concern does not address the underlying difficulties of regulation.

If any public interest can be identified concerning milk regulation it is that Montanans would be better served by deregulation of prices at the retail and wholesale levels. A program to this end could be instituted gradually under legislative guidelines. Considering the power of several distributors, it may be politically wise to allow the Milk Control Board discretion to reimplement controls on a temporary basis in marketing areas experiencing chaotic conditions. If this power is granted, it should be exercised only with extreme caution by the board. The potential for abuse of this power is great because of inevitable presence of strong and selfish interests. Although a good case can be made for retaining controls on producer pricers, it would be wiser over the long run to suspend them in conjunction with establishment of cooperative processing and/or marketing arrangements. A program of this kind would allow producers to maintain their farms while allowing them to take advantage of economies of scale available from cooperative enterprise. Diffusion of economic power should

make monopolization of political influence less probable.

The state also should apply a vigorous antitrust policy (including posting of prices) to the dairy industry, rather than acquiescing in the misconception that price controls preserve competition. Montana has machinery for this task in the Department of Justice's Antitrust Enforcement Bureau. However, the legislature will have to beef up the Bureau's budget. This will require convincing some legislators that antitrust policy would deal more effectively with anti-competitive practices than a regulatory program which does more to hide these practices than control them.

It cannot be overemphasized that organized consumer activity will be necessary to achieve much of the stated program, regardless of whether it is achieved legislatively or through popular initiative. Policy makers, dairymen, and the public should take note that the Federal Trade Commission has recently demonstrated a willingness to overturn state laws which countenance monopoly rather than protect the citizenry. Montanans may soon have to decide whether they should clean their own house before "Big Brother" in Washington extends a helping, but possibly unwelcome, hand.

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